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Research Update:

Chilean Conglomerate Empresas Copec S.A. Downgraded To 'BBB-' From 'BBB' On Higher Leverage, Outlook Stable

May 20, 2020

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Rating Action Overview

- E-Copec is one of the largest private industrial holding companies in Chile with EBITDA of about $2 billion in 2019We expect the COVId-19 outbreak to take a toll on the operating performance of the group's two main subsidiaries, Celulosa Arauco y Constitucion S.A. (Arauco) and Compania de Petroleos de Chile COPEC S.A. (Copec).
- Empresas Copec S.A.'s (E-Copec's) leverage was already high amid the low pulp prices and significant investments the past few years, while it's in the middle of the construction of new pulp mill.
- Leverage will peak at about 5.0x this year and will likely only slip to 3.0x-3.5x in 2021.
- On May 20, 2020, S&P Global Ratings lowered its issuer credit rating on E-Copec to 'BBB-' from 'BBB'.
- The stable outlook reflects our expectations that the company will start deleveraging considerably next year, with debt to EBITDA consistently below 4.0x.

Rating Action Rationale

The pandemic will further dent E-Copec's EBITDA in 2020. We expect Arauco's revenue and EBITDA to fall about 8% and 15% further respectively this year due to persistently low pulp prices and weak demand for wood and panel products (please refer to "Chilean Pulp and Panel Producer Arauco 'BBB-' Ratings Affirmed On Capitalization Announcement, Outlook Remains Negative," published May 20, 2020). Additionally, the group's fuel distribution subsidiary, Copec, which has been historically a much more stable business, will take a considerable hit from the extensive lockdowns and recession. We forecast a 15%-18% drop in the company's revenue and EBITDA. (Please refer to "Compañía de Petróleos de Chile Downgraded To 'BBB-' From 'BBB' On Higher Leverage Amid Economic Downturn, Outlook Stable," published April 15, 2020). This two subsidiaries represent about 85% of the group's operations and we believe E-Copec's EBITDA will drop to $1.6 billion - $1.7 billion from $2.0 billion in 2019, which was already a difficult year.

The group has maintained an intense investment activity in the past few years. Between 2016 and 2018, Copec acquired Mapco's assets in the U.S. and those of Exxon Mobil in the Andean region, in line with its international expansion strategy, for a total of about $1.0 billion. In 2019, Arauco started to renovate the Arauco mill, which includes the construction of a new pulp mill for about $2.3 billion until 2021. Additionally, Arauco completed some investments and acquisitions at its wood and panel business, such as the Grayling mill in Michigan and acquisition of assets in Brazil and Mexico. Moreover, through Alxar, E-Copec is participating in a copper mining project in Peru--Mina Justa—the construction of which will be completed by the year-end at a cost of $600 million for the group. Amid all these initiatives, the group has been running free cash flow deficits since 2019, and we forecast the same trend in 2020 and 2021.

Leverage will remain above historical levels through 2021. Historically, E-Copec has targeted a leverage metric of less than 3.0x, and more specifically, closer to 2.5x. Following the intense investments and Arauco's weaker operations following the collapse in pulp prices last year, the group's leverage metric climbed to 3.6x in 2019. Moreover, the pernicious impact of COVID-19 across all the industries the group operates, we believe its leverage could peak at about 5.0x this year. In our view, the recovery in E-Copec's markets and its countercyclical efforts will rapidly bring down leverage in 2021, but it will most likely remain above historical levels. In 2021, we expect the recovery in volumes in the fuel business, a 12%-15% increase in average pulp prices, and the partial start-up of the Arauco mill to strengthen EBITDA to $2.2 billion - $2.3 billion. Furthermore, we believe the group will sell some assets to support Arauco's capital increase and the overall group capital structure. For instance, the group has already hired a bank to assess the sale of Sonacol.

Outlook

The stable outlook on E-Copec reflects our expectation that it will rapidly deleverage in 2021 to close or below 3.5x. We expect the ramp-up of MAPA, higher volumes in the fuel business, and some recovery in pulp prices to strengthen the group's operating cash flows in 2021.

Downside scenario

If E-Copec's leverage rises due to higher-than-expected investments or weaker consolidated performance, we could revise the outlook to negative or even lower the ratings in the next two years. Such a rating action would be associated to net debt to EBITDA persistently above 4.0x or funds from operations (FFO) to net debt persistently lower than 20%, which would correspond to consolidated EBITDA persistently of less than $1.85 billion and average realized pulp prices persistently close to $500 per ton, assuming Copec's operating performance remains unchanged. We could also take these actions if the group is unable to complete asset sales and its EBITDA falls by about $250 million against our base case in 2021.

Upside scenario

We could raise the ratings in the next two years if the group's leverage metrics improves markedly, with debt to EBITDA falling and remaining persistently below 3.0x and FFO to debt improving to close or above 30%. That could occur if pulp prices rebound sharply or if the group sell non-core assets beyond those incorporated in our base-case scenario. A positive rating action would be consistent with pulp prices about 8%-10% higher in 2021 or additional assets sales for $700 million -$800 million compared to our base case.

Company Description

E-Copec is one of the largest private industrial holding companies in Chile with revenue of about $24 billion in 2019. It owns pulp, wood products, forestry, energy, fuel distribution, fishing, and mining businesses. The group holds important market shares and benefits from favorable cost positions at most of its subsidiaries. The following are E-Copec's main operating assets:

- Arauco (BBB-/Negative/--; stand-alone credit profile [SACP]: bbb-): The company focuses on forest management, and producing and selling market pulp and wood products. Arauco is one of the world's largest pulp producers, with a capacity of almost 4 million tons of bleached and unbleached kraft pulp (on an attributable basis). Arauco has three main businesses: pulp, wood products (panels and solid wood) and forestry, and a complementary business of energy. Currently, the company generates 60%-65% of group's total EBITDA.
- Copec (BBB-/Stable/--); The largest Chilean gas and fuel distribution company. Copec has an indirect controlling stake of 58.5% in Organizacion Terpel S.A. (Terpel; not rated), which is the leader in the Colombian fuel and lubricant distribution market, and has presence in the fuel and lubricants distribution markets of Panama, Ecuador, Chile, Dominican Republic, and Peru. Copec recently acquired a 100% stake in Mapco, a U.S.-based operator of 348 service stations across seven states. The company operates a total network of 3,320 fuel stations and accounts for about 25% of the group's EBITDA.
- Abastible (not rated): One of the largest liquefied petroleum gas (LPG) distributors in South America. It operates in Chile, Colombia (through Norgas with a 51% stake), Peru (under the Solgas brand), and Ecuador (through Duragas). Abastible, together with its assets, represents 7%-9% of the group's total EBITDA.

Our Base-Case Scenario

- COVID-19 will prevent pulp prices from rising considerably in 2020. We assume average realized prices of $580-$550 per ton in 2020, and about $625 in 2021. Pulp production of 3.7 million - 3.8 million tons in 2020. With the ramp-up of the new pulp mill (MAPA), we expect total production to reach 4.4 million tons in 2021.
- A decline of around 5% in sold panels volume in 2020, and a 10% growth in 2021. This includes capacity additions from the gradual ramp-up at the Grayling plant in the U.S. and around 500,000 cubic meters (m3) from the recently acquired facilities in Mexico.
- As a result, Arauco's EBITDA should fall to $0.9 billion - $1.0 billion in 2020 from $1.1 billion in 2019, but recover to $1.4 billion - $1.5 billion in 2021 amid better prices and higher panel volumes.
- A 6%-7% drop in fuel volumes sold amid recession in 2020. In 2021, volumes growth largely linked to GDP expansion in each market, leading to an overall volume year-over-year increase of 3%-4%.
- In Chile, fuel prices falling about 16% in 2020 (mainly due to lower oil prices), but rising 18%-20% in 2021. In Colombia, a 13% price drop in 2020 and 20% growth in 2021. Copec's EBITDA of about $460 million in 2020 and close to $600 million in 2021.

- Abastible's EBITDA falling 5%-10% in 2020 due to the Chilean peso's depreciation and growing 8%-10% in 2021.
- Dividends from subsidiaries (Metrogas and AGESA, not rated) registered under the equity method at $60 million - $65 million per year. Mina Justa to start paying about $150 million in dividends in 2022.
- Total dividend payout ratio of 30%, in line with the revised dividend policy.
- Capex assumptions follow each subsidiary's investment plan, plus capex for the Mina Justa project. Capex to total $1.8 billion - $1.9 billion in 2020, and to fall to $1.5 billion - $1.6 billion in 2021.
- Asset sales for $500 million - $600 million in 2021.

Based on these assumptions, we arrive at the following credit metrics for E-Copec:

- Total consolidated EBITDA of about $1.7 billion in 2020, and improve to $2.2 billion - $2.3 billion in 2021, compared to $2.0 billion in 2019.
- Debt to EBITDA close to 5.0x in 2020 and 3.0x-3.5x in 2021, compared to 3.6x in 2019; and
- FFO to debt about 15% in 2020 and 20%-25% in 2021, compared to 15% in 2020.

Liquidity

We assess the liquidity of E-Copec as adequate because we expect sources of cash to cover uses by about 1.3x in the next 12 months. Also, it reflects that the group and its main subsidiaries have managed to maintain sound liquidity position amid investments and acquisitions, without short-term pressure or limiting access to banks and capital markets, confirming its sound relationship with lenders and standing in the markets. Moreover, we believe the companies can absorb high-impact, low-probability events with limited need for refinancing, given that capital expenditures are flexible, ability to sell several assets, and the operating subsidiaries can count on group support, as seen recently in capital injections or intercompany loans to Copec and Arauco, respectively. The group's companies also benefit from generally prudent risk management, because we believe management is able to anticipate potential setbacks and take necessary actions, such as accessing committed credit lines, in the case of Arauco.

Principal Liquidity Sources:

- $2.3 billion cash holdings as of December 2019;
- Arauco's revolving credit facility for $375 million;
- FFO of around $1.1 billion net of operating leases

Principal Liquidity Uses:

- Short-term maturities of around $800 million as of December 2019
- Total capex of $1.8 billion - $1.9 billion;
- Working capital needs of $136 million; and
- Dividend payments of about $55 million in line with the 30% dividend payout over 2019 results.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)

Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Empresas Copec S.A.		
Issuer Credit Rating	BBB-/Stable/--	BBB/Negative/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.